

**Letter of Findings: 04-20120255**  
**Sales and Use Tax**  
**For the Years 2008, 2009, and 2010**

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**ISSUE**

**I. Sales and Use Tax – Manufacturing Exemption.**

**Authority:** IC § 6-2.5-1-2; IC § 6-2.5-2-1; IC § 6-2.5-3-1; IC § 6-2.5-3-2; IC § 6-2.5-3-4; IC § 6-2.5-4-1; IC § 6-2.5-5-3; IC § 6-2.5-5-5.1; IC § 6-8.1-5-1; [45 IAC 2.2-5-8](#); [45 IAC 2.2-5-11](#); [45 IAC 2.2-5-12](#); Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289 (Ind. Tax Ct. 2007); Indiana Dep't. of State Revenue v. Rent-A-Center East, Inc., 963 N.E.2d 463 (Ind. 2012); Indiana Dep't of State Revenue v. RCA Corp., 310 N.E.2d 96 (Ind. Ct. App. 1974); Rhoads v. Indiana Dep't of State Revenue, 774 N.E.2d 1044 (Ind. Tax Ct. 2002); USAir, Inc. v. Indiana Dep't of State Revenue, 623 N.E.2d 466 (Ind. Tax Ct. 1993); Indiana Dep't. of State Revenue v. Cave Stone, Inc., 457 N.E.2d 520 (Ind. 1983); Mumma Bros. Drilling Co. v. Department of Revenue, 411 N.E.2d 676 (Ind. Ct. App. 1980); General Motors Corp. v. Indiana Dep't. of State Revenue, 578 N.E.2d 399 (Ind. Tax Ct. 1991); Indiana Dep't. of Revenue v. Interstate Warehousing, Inc., 783 N.E.2d 248 (Ind. 2003).

Taxpayer protests the assessment on purchases of tangible personal property.

**STATEMENT OF FACTS**

Taxpayer, an out-of-state company, has a facility in Indiana which manufactures steel products. The Indiana Department of Revenue ("Department") conducted a Sales/Use tax audit of Taxpayer's business records for tax years 2008, 2009, and 2010. The Department and Taxpayer agreed to utilize a sample selected from Taxpayer's records and a projection method to perform the audit. Pursuant to the audit, the Department determined that Taxpayer did not pay sales tax or self-assess use tax on certain tangible personal property which Taxpayer used in its business activities. The Department's audit thus assessed additional use tax and statutory interest on those purchases of tangible personal property.

Taxpayer only protests the imposition of use tax on fifteen (15) items, including, but not limited to, transformers, filter reactors, reactor coils, harmonic filters, and bushing replacement (the "Items at issue"). The Items at issue were replacements of an electrical power transmission system located at two separate substations (also referred to as the "First substation" and the "Second substation"). The First substation is at the facility of an electricity producer (the "Electricity Producer") and the Second substation is located at Taxpayer's Indiana facility. The Items at issue were solely used to "step-down" the voltage of the electricity, so Taxpayer could eventually receive the usable voltage – namely, 34.5 Kilovolts ("kV") and/or 13.8kV – of the electricity at its Indiana facility. An administrative hearing was held and this Letter of Findings results. Further facts will be supplied as required.

**I. Sales and Use Tax – Manufacturing Exemption.**

**DISCUSSION**

The Department's audit assessed use tax on the Items at issue which Taxpayer used in two substations to "step down" the higher voltage of the electricity to a lower voltage of the electricity. The Department's audit noted, in relevant part, that:

Due to [Taxpayer's] power requirements to operate [its] manufacturing facility [Taxpayer] had to arrange with [the Electricity Producer and local public utilities] to supply electrical power to [Taxpayer's Indiana] facility. [Taxpayer] has purchased equipment which has been taxed in this audit. The equipment in question includes:

- 1) Equipment owned by [Taxpayer] that is located at the [Electricity Producer] power plant....
- 2) Equipment located on [Taxpayer's Indiana] facility at the main substation....

Equipment at the [Electricity Producer's] plant [i.e., the First substation] allows [Taxpayer] to take the electrical power and "step down" the voltage from 765 [kV] to 138 [kV]. These transformers which lower the voltage are owned by [Taxpayer]. Once the voltage is lowered the power is carried to [Taxpayer's] plant thru two lines which lead to the **main substation** [i.e., the Second substation] that is located on [Taxpayer's] property. This main substation is located at [Taxpayer's] Utility Yard where the power is again "stepped down" from 138 [kV] and transferred to four (4) smaller units in their **primary yard**. At this point the power is handled by the four smaller units where the power is now entering the plant, 2 units at [34.5kV] and 2 units at 13.8 [kV]. (**Emphasis is original** in the Audit Summary, page 6).

As a result, the Department's audit determined that "the equipment used prior to the four units which is the point of entry into [Taxpayer's facilities] is transmission equipment and is subject to taxation." The Department's audit also determined that the four units in Taxpayer's primary yard and the related equipment which were used to connect the 34.5kV/13.8kV lines – the usable electricity – with Taxpayer's manufacturing machinery and equipment were directly used in direct production and, thus, were exempt pursuant to [45 IAC 2.2-5-8](#).

Taxpayer claimed that it was entitled to the manufacturing exemption on the Items at issue. Taxpayer referred to its arrangements with the Electricity Producer and local public utilities, stating that the Items at issue were used for its "electrical distribution system" to manufacture its steel products. Thus, Taxpayer asserted that it was entitled to the manufacturing exemption pursuant to [45 IAC 2.2-5-8\(c\)](#), example (2)(B), and [45 IAC 2.2-5-8\(g\)](#), example 5.

As a threshold issue, all tax assessments are prima facie evidence that the Department's assessment of tax is presumed correct. "The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made." IC § 6-8.1-5-1(c); *Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue*, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007); *Indiana Dep't. of State Revenue v. Rent-A-Center East, Inc.*, 963 N.E.2d 463, 466 (Ind. 2012).

Indiana imposes an excise tax called "the state gross retail tax" (or "sales tax") on retail transactions made in Indiana. IC § 6-2.5-2-1(a). A person who acquires property in a retail transaction (a "retail purchaser") is liable for the sales tax on the transaction. IC § 6-2.5-2-1(b). Indiana also imposes a complementary excise tax called "the use tax" on "the storage, use, or consumption of tangible personal property in Indiana if the property was acquired in a retail transaction, regardless of the location of that transaction or of the retail merchant making that transaction." IC § 6-2.5-3-2(a). "Use" means the "exercise of any right or power of ownership over tangible personal property." IC § 6-2.5-3-1(a). The use tax is functionally equivalent to the sales tax. See *Rhoads v. Indiana Dep't of State Revenue*, 774 N.E.2d 1044, 1047 (Ind. Tax Ct. 2002).

By complementing the sales tax, the use tax ensures that non-exempt retail transactions (particularly out-of-state retail transactions) that escape sales tax liability are nevertheless taxed. *Id.*; *USAir, Inc. v. Indiana Dep't of State Revenue*, 623 N.E.2d 466, 468–69 (Ind. Tax Ct. 1993). The use tax ensures that, after such goods arrive in Indiana, the retail purchasers of the goods bear their fair share of the tax burden. To trigger imposition of Indiana's use tax, tangible personal property must (as a threshold matter) be acquired in a retail transaction. *Id.* A taxable retail transaction occurs when (1) a party acquires tangible personal property as part of its ordinary business for the purpose of reselling the property; (2) that property is then exchanged between parties for consideration; and (3) the property is used in Indiana. See IC § 6-2.5-1-2; IC § 6-2.5-4-1(b), (c); IC § 6-2.5-3-2(a).

Generally, all purchases of tangible personal property by persons engaged in the direct production, manufacture, fabrication, assembly, or finishing of tangible personal property are taxable. [45 IAC 2.2-5-8\(a\)](#). An exemption from use tax is granted for transactions where the sales tax was paid at the time of purchase pursuant to IC § 6-2.5-3-4. There are also additional exemptions from sales tax and use tax. A statute which provides a tax exemption, however, is strictly construed against the taxpayer. *Indiana Dep't. of State Revenue, Sales Tax Division v. RCA Corp.*, 310 N.E.2d 96, 97 (Ind. Ct. App. 1974). "[W]here such an exemption is claimed, the party claiming the same must show a case, by sufficient evidence, which is clearly within the exact letter of the law." *Id.* at 101.

IC § 6-2.5-5-3, in relevant part, states:

(b) Except as provided in subsection (c), transactions involving manufacturing machinery, tools, and equipment are exempt from the state gross retail tax if the person acquiring that property acquires it for **direct use in the direct production, manufacture, fabrication, assembly, extraction, mining, processing, refining, or finishing of other tangible personal property.**

(c) The exemption provided in subsection (b) **does not apply to transactions involving distribution equipment or transmission equipment acquired by a public utility engaged in generating electricity. (Emphasis added).**

IC § 6-2.5-5-1(b) provides:

Transactions involving tangible personal property are exempt from the state gross retail tax if the person acquiring the property acquires it **for direct consumption as a material to be consumed in the direct production of other tangible personal property** in the person's business of manufacturing, processing, refining, repairing, mining, agriculture, horticulture, floriculture, or arboriculture. **(Emphasis added).**

Thus, the Legislature granted Indiana manufacturers a sales tax exemption for certain purchases, which are for "direct use in direct production, manufacture... of other tangible personal property." In enacting the exemption, the Legislature clearly did not intend to create a global exemption for any and all equipment which a manufacturer purchases for use within its manufacturing facility. "Fairly read, the exemption was meant to apply to capital equipment that meets the 'double direct' test." *Mumma Bros. Drilling Co. v. Department of Revenue*, 411 N.E.2d 676, 678 (Ind. Ct. App. 1980). The capital equipment "in order to be exempt, (1) must be directly used by the purchaser and (2) be used in the direct production, manufacture, fabrication, assembly, extraction, mining, processing, refining, or finishing of tangible personal property." *Indiana Dep't. of State Revenue v. Cave Stone, Inc.*, 457 N.E.2d 520, 525 (Ind. 1983). "The test for directness requires the equipment to have an 'immediate link with the product being produced.'" *Id.* Accordingly, the sales tax exemption is applicable to that equipment which meets the "double direct" test and is "essential and integral" to the manufacture of taxpayer's tangible personal property. *General Motors Corp. v. Indiana Dep't. of State Revenue*, 578 N.E.2d 399, 401 (Ind. Tax Ct. 1991). The application of Indiana's double-direct manufacturing exemptions often varies based on a determination of when a taxpayer's manufacturing process is considered to have begun and ended.

An exemption applies to manufacturing machinery, tools, and equipment directly used by the purchaser in direct production. [45 IAC 2.2-5-8\(a\)](#). Machinery, tools, and equipment are directly used in the direct production process if they have an immediate effect on the article being produced. [45 IAC 2.2-5-8\(c\)](#). A machine, tool, or piece of equipment has an immediate effect on the product being produced if it is an essential and integral part of an integrated process that produces the product. Id. An integrated process is one where the total production process is comprised of activities or steps that are functionally interrelated and where there is a flow of "work-in-process." [45 IAC 2.2-5-8\(c\)](#), example 1.

[45 IAC 2.2-5-8\(k\)](#) describes direct production as the performance of an integrated series of operations which transforms the matter into a form, composition or character different from that in which it was acquired, and that the change must be substantial resulting in a transformation of the property into a different and distinct product.

The exemption for direct use in production is further explained at [45 IAC 2.2-5-11](#), in part, as follows:

(a) The state gross retail tax shall not apply to sales of tangible personal property to be directly used by the purchaser in the direct production or manufacture of any manufacturing or agricultural machinery, tools, and equipment described in [IC 6-2.5-5-2](#) or 6-2.5-5-3 [[IC 6-2.5-5-3](#)].

(b) The exemption provided in this regulation [[45 IAC 2.2](#)] extends only to tangible personal property directly used in the direct production of manufacturing or agricultural machinery, tools, and equipment to be used by such manufacturer or producer.

(c) The state gross retail tax shall not apply to purchases of tangible personal property to be directly used by the purchaser in the production or manufacturing process of any manufacturing or agricultural machinery, tools, or equipment, provided that the machinery, tools, and equipment are directly used in the production process; i.e., they have an immediate effect upon the article being produced or manufactured. The property has an immediate effect on the article being produced if it is an essential and integral part of an integrated process which produces tangible personal property.

(d) For the application of the rules [subsections] above, refer to Regs. 6-2.5-5-3 [[45 IAC 2.2-5-8](#) through [45 IAC 2.2-5-10](#)] with respect to tangible personal property used directly in the following activities: pre-production and post-production activities; storage; transportation; tangible personal property which has an immediate effect upon the article produced; maintenance and replacement; testing and inspection; and managerial, sales, and other nonoperational activities.

The exemption for direct consumption in production is further explained at [45 IAC 2.2-5-12](#), in part, as follows:

(a) The state gross retail tax shall not apply to sales of any tangible personal property consumed in direct production by the purchaser in the business of producing tangible personal property by manufacturing, processing, refining, or mining.

(b) The exemption provided by this regulation [[45 IAC 2.2](#)] applies only to tangible personal property to be directly consumed in direct production by manufacturing, processing, refining, or mining. It does not apply to machinery, tools, and equipment used in direct production or to materials incorporated into the tangible personal property produced.

(c) The state gross retail tax does not apply to purchases of materials to be directly consumed in the production process or in mining, provided that such materials are directly used in the production process; i.e., they have an immediate effect on the article being produced. The property has an immediate effect on the article being produced if it is an essential and integral part of an integrated process which produces tangible personal property.

[45 IAC 2.2-5-8\(d\)](#) states:

Pre-production and post-production activities. "Direct use in the production process" begins at the point of the first operation or activity constituting part of the integrated production process and ends at the point that the production has altered the item to its completed form, including packaging, if required.

[45 IAC 2.2-5-8\(f\)](#) provides:

(1) Tangible personal property used for moving raw materials to the plant prior to their entrance into the production process is taxable.

(2) Tangible personal property used for moving finished goods from the plant after manufacture is subject to tax.

(3) Transportation equipment used to transport work-in-process or semi-finished materials to or from storage is not subject to tax if the transportation is within the production process.

(4) Transportation equipment used to transport work-in-process, semi-finished, or finished goods between plants is taxable, if the plants are not part of the same integrated production process.

[45 IAC 2.2-5-8\(g\)](#) further states:

**"Have an immediate effect upon the article being produced":** Machinery, tools, and equipment which are used during the production process and which have an immediate effect upon the article being produced are exempt from tax. Component parts of a unit of machinery or equipment, which unit has an immediate effect on the article being produced, are exempt if such components are an integral part of such manufacturing unit.

**The fact that particular property may be considered essential to the conduct of the business of**

**manufacturing because its use is required either by law or by practical necessity does not itself mean that the property "has an immediate effect upon the article being produced". Instead, in addition to being essential for one of the above reasons, the property must also be an integral part of an integrated process which produces tangible personal property. (Emphasis added).**

Additionally, [45 IAC 2.2-5-8\(j\)](#) provides:

**Machinery, tools, and equipment used in managerial sales, research, and development, or other non-operational activities, are not directly used in manufacturing and, therefore, are subject to tax.**

This category includes, but is not limited to, tangible personal property used in any of the following activities: management and administration; selling and marketing; exhibition of manufactured or processed products; safety or fire prevention equipment which does not have an immediate effect on the product; space heating; ventilation and cooling for general temperature control; illumination; heating equipment for general temperature control; and shipping and loading. **(Emphasis added).**

In *Indiana Dep't. of Revenue v. Interstate Warehousing, Inc.*, 783 N.E.2d 248 (Ind. 2003), the taxpayer, Interstate Warehousing, Inc. ("Interstate"), claimed that it was entitled to an exemption under IC § 6-2.5-5-5.1 on its consumption of the electricity used to convert ammonia from a gas to a liquid. Interstate Warehousing, 783 N.E. 2d at 249. The Tax Court ruled in favor of the taxpayer. The Indiana Supreme Court, in reversing the Tax Court's determination, found that the taxpayer did not qualify for the exemption in two respects: the court found that (1) the taxpayer was not engaged in the "production of other tangible personal property" (namely, the "distinct marketable good" requirement); and (2) the taxpayer was not in the business of "manufacturing, processing, refining, repairing, mining, agriculture, horticulture, floriculture, or arboriculture" (namely, the "transformation" requirement). Id. at 250. The Indiana Supreme Court, in pertinent part, explained that:

Interstate uses electricity to cool gaseous ammonia to liquid form and then circulates the liquid through its warehouse facilities to cool the air. When the temperature of the ammonia begins to rise, it is again chilled. The ammonia stays in the refrigeration system, which was referred to as "closed loop." While it is certainly true that there is some transformation of the ammonia from gas to liquid form as a consequence of the consumption of electricity, such transformation alone is not sufficient to constitute "production of other tangible personal property" under the statute. **By "production of other tangible personal property," the Legislature meant that the taxpayer must use the electricity to transform the ammonia into a distinct marketable good. That does not occur here; the liquid ammonia is never marketed.**

...

Interstate [does not] perform an integrated series of operations resulting in a transformed end product to Interstate's customer.... The cool air merely maintains the customer's previously manufactured goods. There is no substantial change in "form, composition, or character" to those goods. **The cold air is only incidental to the service of storing previously manufactured goods. (Emphasis added).**

Id. at 250-52.

As mentioned above, only when the use of the tangible personal property has met the "double direct" standard, is a taxpayer entitled to the manufacturing exemption. In this instance, Taxpayer claimed that the Items at issue were part of its integrated "electrical distribution system," which was "used to produce and/or supply electricity to exempt manufacturing equipment used in direct production." Specifically, Taxpayer stated that, in order to receive adequate electricity for its manufacturing production, it made several special arrangements with the Electricity Producer and the local public utilities. Taxpayer explained that, under the special arrangements, Electricity Producer sold electricity at a higher voltage (765kV) to the local public utilities, which owned a point of delivery on the Electricity Producer's transmission lines; in turn, the local public utilities sold the electricity rated at the same 765kV to Taxpayer. As a result, Taxpayer had to step down the unusable 765kV electricity immediately to a lower voltage (138kV) at the First substation which is also connected to Electricity Producer's transmission line and then transmitted the electricity via its own 138kV transmission lines to the Second substation, where the unusable 138kV electricity was again further stepped down to a lower voltage of electricity. Taxpayer further claimed that under the special arrangements, "these transmission lines were designed to [Taxpayer's] specifications and not those of a local public utility"; thus, it was entitled to the manufacturing exemption pursuant to [45 IAC 2.2-5-8\(c\)](#), example (2)(B), and [45 IAC 2.2-5-8\(g\)](#), example (5). Taxpayer provided a statement, explaining the history of Taxpayer's substation at Electricity Producer's facility. Taxpayer also offered copies of "Substation Supply Agreement," Substation maintenance agreement, and "Special Contract for Electric Power Service to [Taxpayer]" to support its protest.

Taxpayer's documentation demonstrated that it employed the Electricity Producer to engineer, design, construct, sell, and subsequently maintain the First substation which was built on Electricity Producer's property. Pursuant to that agreement, Taxpayer would have to assign the ownership of the First substation to the local public utilities. Although Taxpayer claims that it continues to own the First substation, this is apparently in violation of the agreement as presented to the Department. Taxpayer's documentation showed that the First substation contains a series of 765/138 kV transformers and related equipment used to "step down" the unusable voltage of the electricity, not to produce the electricity for sale. Similarly, Taxpayer's documentation showed that the transformers and related equipment used at the Second substation were also solely used to step down the



unusable voltage of the electricity. Taxpayer did not produce the electricity for sale. Thus, Taxpayer here, like the taxpayer in Interstate Warehousing, did not use the Items at issue to produce tangible personal property for sale; rather, the Items at issue were used solely to step down the voltage of the unusable electricity so the electricity can be transmitted subsequently to Taxpayer's electrical units. Only after the unusable electricity was further converted to the usable electricity, Taxpayer's electronic units and switchgears were used to connect the usable electricity to its machinery and equipment used in its steel production.

Taxpayer's documentation also demonstrated that the Items at issue did not have an immediate effect on its steel production. Taxpayer argued that it relied on [45 IAC 2.2-5-8\(c\)](#), example (2)(B), which provides:

(c) The state gross retail tax does not apply to purchases of manufacturing machinery, tools, and equipment to be directly used by the purchaser in the production process provided that such machinery, tools, and equipment are directly used in the production process; i.e., they have an immediate effect on the article being produced. Property has an immediate effect on the article being produced if it is an essential and integral part of an integrated process which produces tangible personal property.

--EXAMPLES--

...

(2) The following types of equipment constitute essential and integral parts of the integrated production process and are, therefore, exempt. The fact that such equipment may not touch the work-in-process or, by itself, cause a change in the product, is not determinative.

...

**(B) An electrical distribution system, including generators, transformers, electrical switchgear, cables inside or outside the plant, and related equipment used to produce and/or supply electricity to exempt manufacturing equipment used in direct production. (Emphasis in original in**

Taxpayer's September 27, 2012 Letter, page 3).

Taxpayer also referred to [45 IAC 2.2-5-8\(g\)](#), example (5), which provides that:

A metal manufacturer uses a variety of electrically-powered production equipment which has differing voltage and power requirements. Power cables used to bring electricity to the manufacturer's plant are taxable.

**Switch gears, transformers, conduits, cables, controls, rectifiers, and generators which are interconnected with the production equipment and serve as an electrical distribution system for such equipment are exempt from tax. (Emphasis in original in Taxpayer's September 27, 2012 Letter, page 3-4).**

Taxpayer's documentation, however, demonstrated that the Items at issue were not used "to produce and/or supply electricity to exempt manufacturing equipment used in direct production." Nor did Taxpayer's documentation demonstrate that the Items at issue at the First substation and the Second substation were directly "interconnected with the production equipment." Rather, the Items at issue were used to step down the unusable electricity at both substations. Taxpayer's documentation showed that the electricity after the First substation remained unusable, and, thus, the electricity was not able to "produce and/or supply electricity to exempt manufacturing equipment used in direct production." Similarly, Taxpayer's documentation also demonstrated that the electricity at the Second substation remained unusable and had to connect to several and separate electrical units located at Taxpayer's property. Thus, the electricity at the Second substation remained unusable and was not used "to produce and/or supply electricity to exempt manufacturing equipment used in direct production."

Taxpayer's documentation demonstrated that only after the point of the electrical units, was the unusable electricity converted to usable electricity and connected to the control house of its plant, which contained switchgears to power the machinery and equipment for Taxpayer's steel production. Thus, Taxpayer's use of the Items at issue before the point of the electrical units is at best pre-production because the Items at issue did not have an immediate effect upon the machinery and equipment directly used in Taxpayer's direct production. Thus, Taxpayer's reliance on [45 IAC 2.2-5-8\(c\)](#), example (2)(B), and [45 IAC 2.2-5-8\(g\)](#), example (5) is misplaced.

In conclusion, [45 IAC 2.2-5-8\(c\)](#) specifically provides that "purchases of manufacturing machinery, tools, and equipment" must "be directly used by the purchaser in the production process provided that such machinery, tools, and equipment are directly used in the production process; i.e., they have an immediate effect on the article being produced." [45 IAC 2.2-5-8\(g\)](#) explains that "[h]ave an immediate effect upon the article being produced" will require that "[m]achinery, tools, and equipment which are used during the production process and which have an immediate effect upon the article being produced are exempt from tax." Taxpayer's use of the Items at issue may be considered essential to conduct its business of manufacturing because its use is required either by law or by practical necessity. However, as discussed above, "[t]he fact that particular property may be considered essential to the conduct of the business of manufacturing because its use is required either by law or by practical necessity does not itself mean that the property has an immediate effect upon the article being produced." Given the totality of the circumstances, in the absence of other supporting documentation, the Department is not able to agree that Taxpayer met its burden of proof demonstrating that the assessment is wrong.

#### FINDING

Taxpayer's protest is respectfully denied.

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